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SWFs and the Economic Development Agenda: Reflections on the "Arab Spring"

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Without preference to the Arab world, economic challenges fuel social pressures. Local decision makers are forced to prioritize the allocation of sometimes scarce economic and social resources, leaving the evaluation of the benefits and costs of these decisions to local citizenry. Whether favorable or not, citizen views add a political dimension to the governance dilemma. As the Arab Spring has ably demonstrated, resulting voices of displeasure, even in non-democratic countries, can lead to regime change with compounding complications.

Among many of the Middle East/North Africa (MENA) region countries, a common problem persists: the lack of a thriving and diversified private sector to facilitate job creation, social development, and the move away from largely resource-based economies. Economic development is inhibited by the lack of foreign direct investment and in flows of capital. What role can Sovereign Wealth Funds (SWFs) play in the strengthening of the pillars of a domestic economy if they are mandated to investment externally? What hope will citizens have that the benefits of a SWF will translate into the social development necessary to meet their basic needs?

The rise of SWFs, according to Edwin M. Truman of the Peterson Institute, is due to a redistribution of wealth and economic power from the developed world to that of other industrial countries, and an increasing role of governments in managing financial wealth in the current global political economy.[2] SWFs are thus integral to how governments decide to invest internationally and domestically, and their relation to the government-led decision process varies along a spectrum of influence, from total oversight and control to that of a transparent autonomous body. Where a SWF falls on this spectrum is a function of political efficacy, government mandate, level of transparency, and human capacity, among others. In addition, the nature and direction of investments made by SWFs under government mandate impact the interests of various stakeholders including the SWF itself, the government (as shareholder), the citizens of the country, market participants, and foreign governments and citizens in the global economy.[3] Given the disparate interests of the

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[2] Edwin M. Truman, *Sovereign Wealth Funds: Threat or Salvation,* Peterson Institute, 2009.
[3] Ibid.

stakeholders involved in the investment process, it becomes difficult to implement decisions that benefit all. The decision thus becomes one of optimizing benefits with positive effect to most stakeholders in order to advance the investment allocation process.

Today, substantial investment is required—especially in the development of social and real infrastructure assets. A rise in infrastructure investment can benefit long-term investors who seek to match liabilities with the long-term revenue stream from infrastructure investments. Recent asset allocation shifts by the China Investment Corporation (CIC), China's SWF, reflect diversification into real assets due to a perceived risk in global financial markets.[4] CIC has announced its interest in investing in the aged infrastructures of the U.S. and Europe, and will partner with governments to provide the large amounts of capital needed to undertake huge infrastructure projects.[5] The United States is also considering similar investments in an effort to repair an old and damaged infrastructure system.[6]

Political change allows for a new start in building economic and social institutions, to which SWFs may also contribute. A recent report by PricewaterhouseCoopers found that SWFs can have tangible effects on the economic success of the their host countries by helping to lower inflation, reduce government borrowing, and limit foreign exchange rate appreciation brought about by the so-called "Dutch Disease." Of additional interest, the study found that SWFs help to alleviate the perception of corruption in the countries that had established SWFs. In this manner, SWFs may help to boost transparency by providing a clear rules-based system whereby new capital (in the form of resource revenues, for example) is transferred directly into the fund for investment. In this way, a well-governed SWF can manage complex transactions and substantially reduce the opportunity for wealth misappropriation or reallocation by government leadership.[7]

Rather than look abroad to financial assets in the U.S. or Europe, a case can be made for direct investment inwardly in support of the domestic economy. Potentially important costs to the society arise when SWFs invest outside of the country. To the extent that financial capital is invested abroad, the required capital to spur development and innovation at home is displaced or may only be available at a higher cost than would be the case if the SWF invested in the home market. Investing internationally contributes to the growth of foreign economies at the expense of a potentially underdeveloped domestic economy. If a case is to be made for local investment, SWFs can take the lead not only in the efficient allocation of capital to the highest return projects, but also in investing responsibly, transparently, and based upon demonstrably strong governance. This issue is revisited in closing.

With FDI flows to the MENA region predicted to drop over the next year,[8] largely due to the perceived political risk resulting from the Arab Spring and continuing political turmoil, as seen in Syria, domestic capital assumes a greater importance in the pursuit of critical

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[4] CIC website. Available at http://www.china-inv.cn/cicen/

[5] "China keen to invest in Western infrastructure: CIC head," Reuters, November 27, 2011. Available at http://www.reuters.com/article/2011/11/27/us-china-infrastructure-idUSTRE7AQ0YK20111127

[6] "Sovereign Wealth Funds Anticipate Possible American Infrastructure Bank," Sovereign Wealth Fund Institute, September 8, 2011. Available at http://www.swfinstitute.org/swf-article/sovereign-wealth-funds-anticipate-possible-american-infrastructure-bank/

[7] PwC report, "The impact of Sovereign Wealth Funds on economic success." Available at http://www.pwc.co.uk/eng/publications/sovereign-wealth-funds-the-key-to-economic-success.html

[8] World Bank projections 2011. Available at www.worldbank.org

economic development agendas. This necessarily creates a potential for SWFs institutionally to establish greater stability in an economy and to break the "capital scarcity-social needs-political instability" cycle, whereby the economies most need of market development do not receive the capital needed to develop.

An additional benefit attributable to the SWFs institutionally is the aggregation of investable pools of capital. During the recent financial crisis and resulting decline in available capital, SWF investments added capital to struggling companies and financial institutions, providing liquidity to companies that otherwise would have required government support to succeed. As institutional investors, SWFs can also improve pricing efficiency through investment analysis and other due diligence, leading to positive externalities for the development of local and regional capital markets.

Regionally, funds such as the Mubadala Development Company, the Mumtalakat Holding Company, and the Ras Al Khaima Investment Authority (RAKIA) have primarily domestic investment mandates as they seek to develop and diversify their home economies and facilitate technology and knowledge transfer.[9] RAKIA in particular has focused its investment strategy on establishing an environment to allow investors to set up sustainable businesses in the Emirate, by working on simplifying business regulatory procedures and through institution development. For its part, Mumtalakat plays a central role in Bahrain's policy of economic liberalization. Both funds could be models for the leadership role of SWFs in promoting core economic growth and development to mitigate the political tensions manifest by the Arab Spring.

Lest we come to believe the SWF a panacea, we return to the issue of governance and, more broadly, the quality of economic development. Can SWFs, as agents of economic development, efficiently lead a country's quest for socio-economic advancement in a governing environment that itself is not efficient or transparent? Herein is a basic paradox of the SWF, indeed a challenge to its institutional role, which Arab Spring lays bare.

[9] Individual fund websites